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The Law of Financial Conglomerates: The Next Generation

The use of corporate conglomerate structures has become one of the most dominant forms of business in many national and international industrial and commercial sectors. For this reason, it is essential that such operations are subject to proper legal and financial control insofar as they may otherwise create additional forms of risk not covered by existing commercial laws or regulatory practices.

Although the 1990s have experienced a large amount of industrial restructuring through the disposal of various noncore activities in many sectors, the development of increasingly complex conglomerate structures in the financial services area remains one of the most important forms of business expansion.[1] The development of appropriate legal responses to the difficulties created by these new conglomerate forms of business has, however, been slow until now.

One specific difficulty that arises in connection with the development of financial conglomerates or mixed conglomerates, which include at least one financial component in addition to their industrial or commercial operations, is that new forms of financial exposure or legal risk arise as a result of the new commercial and corporate relationships created within the conglomerate in response to which it is essential that new forms of financial supervision and regulation are developed.[2]

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1. For a study of recent trends in international banking, securities, and derivatives markets, see BANK FOR INTERNATIONAL SETTLEMENTS (BIS), INTERNATIONAL BANKING & FINANCIAL MARKETS DEVELOPMENTS (July 1994).

2. For the purposes of this article, the term *regulation* refers to the body of legal rules and regulations or administrative requirements established by financial authorities in order to limit or control the risks assumed by banks and other financial institutions. The term *supervision* refers to the associated or complementary process of monitoring compliance by financial institutions with

The need to develop appropriate supervisory systems and regulatory controls is also particularly necessary in light of the increasing pressures on national and international financial markets generally[3] and of the recent, more specific, instances of financial collapse through poor trading and fraud.[4] The significant global opportunities for further market expansion created under the interim GATS arrangements, agreed in July 1995,[5] also make this a matter of urgent attention.

This article considers some of the basic issues that arise in connection with the development of conglomerate forms of business in the financial services area. Some of the more important recent developments at the international and European levels are then reviewed. Some provisional conclusions are also drawn and tentative recommendations made for the further development of the law in this area.

I. Conglomerate Structures

The term *conglomerate* can be used to refer to any form of business structure that involves at least two distinct forms of industrial activity or service provision.[6]

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these provisions. *See generally* EDWARD P.M. GARDENER, THEORY AND PRACTICE IN BANKING SUPERVISION: SOME REFLECTIONS (1986); DAVID LLEWELLYN, THE REGULATION AND SUPERVISION OF FINANCIAL INSTITUTIONS (1986).

3. *See generally* R.M. PECCHIOLL, ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD), THE INTERNATIONALISATION OF BANKING: THE POLICY ISSUES (1983); J.R.S. REVELL, OECD, BANKING AND ELECTRONIC FUND TRANSFERS (1983); OECD, INTERNATIONAL TRADE IN SERVICES: BANKING (1984); OECD, TRENDS IN BANKING IN OECD COUNTRIES (1985); T.R.G. BINGHAM, OECD, BANKING AND MONETARY POLICY (1985); GUNTHER BROKER, OECD, COMPETITION IN BANKING (1989); INTERNATIONAL MONETARY FUND (IMF), BANKING CRISES: CASES AND ISSUES (V. Sundararajan & Tomas J.T. Balino eds., 1991); OECD, BANKS UNDER STRESS (1992); OECD, TRANSFORMATION OF THE BANKING SYSTEM: PORTFOLIO RESTRUCTURING, PRIVATISATION AND THE PAYMENT SYSTEM (1993). *See also* UNITED NATIONS CENTRE ON TRANSNATIONAL CORPORATIONS (UNCTC), TRANSNATIONAL BANKS: OPERATIONS, STRATEGIES AND THEIR EFFECTS IN DEVELOPING COUNTRIES (1981); UNCTC, TRANSNATIONAL BANKS AND THE INTERNATIONAL DEBT CRISIS (1991); UNCTC, TRANSNATIONAL BANKS AND THE EXTERNAL INDEBTEDNESS OF DEVELOPING COUNTRIES: IMPACT OF REGULATORY CHANGES (1992).

4. In connection with the collapse of the Bank for Credit and Commerce International (BCCI), see generally REPORT INTO THE SUPERVISION OF THE BANK OF CREDIT AND COMMERCE INTERNATIONAL (HMSO, London, Oct. 22, 1992); JOHN KERRY & HANK BROWN, THE BCCI AFFAIR, REPORT TO THE COMMITTEE ON FOREIGN RELATIONS, UNITED STATES SENATE, S. DOC. No. 7, 102d Cong., 2d Sess. (1992). In connection with the collapse of Barings, see BANK OF ENGLAND, REPORT OF THE BOARD OF BANKING SUPERVISION INQUIRY INTO THE CIRCUMSTANCES OF THE COLLAPSE OF BARINGS (1995).

5. Under the interim arrangements agreed to in Brussels on July 26, 1995, although without the full support of the United States, 90% of world financial services, in more than 90 countries, will be covered by the new trade liberalization measures, which will last until the end of 1997. This market is estimated to be worth US$20,000 billion each in terms of world banking assets and deposits, US$10,000 billion of world stock market capitalization, US$10,000 billion of listed bonds, and US$2,000 billion of world insurance premiums. The total global market for financial services is estimated to be worth some US$50 trillion. For an initial report on the interim GATS arrangements, see Frances Williams, *Financial Services Deal Sidelines the U.S.*, FIN. TIMES, July 27, 1995, at 5, and World Trade Organization (WTO), WTO Director-General Hails Financial Services Accord, WTO Press Release No. 18 (July 26, 1995).

6. *See generally* JAMES MAYCOCK, FINANCIAL CONGLOMERATES: THE NEW PHENOMENON (1986); CHARLES R. SPRUILL, CONGLOMERATES AND THE EVOLUTION OF CAPITALISM (1982); HARRY MCVEA, FINANCIAL CONGLOMERATES AND THE CHINESE WALL (1993). Sir Timothy Bevan,

This usually involves groups of companies in one, or more, industrial or commercial sectors. A conglomerate, however, may also consist of a single corporate entity that provides more than one distinct industrial or commercial service.[7]

Although the term *conglomerate* can clearly be applied to industrial or commercial companies, or groups of companies, special difficulties arise with regard to financial conglomerates. From the above, a financial conglomerate is a single company, or group of companies, which provides at least two distinct forms of financial service. This will include, for example, an integrated investment house that provides a range of financial services through internal Chinese Walls,[8] or a group of connected financial companies with the most recent serious concerns arising in connection with the provision of banking, securities, and insurance services from within the same group.

A mixed, or mixed-activity, conglomerate is a group of companies involved in various industrial or commercial sectors with at least one unit which provides financial services from one of the three principal areas of activity noted.[9]

II. Conglomerate Development

The first large conglomerates in the United Kingdom and the United States emerged in the 1960s. Two of the earliest examples were Ling-Temco-Vought, in the United States, and Slater Walker, in the United Kingdom. Both were noted for the absence of any relationship between the various activities undertaken by their component elements and for their early collapse.[10]

In the United Kingdom, the growth of financial conglomerates began in the 1960s with the expansion of the range of services provided by the large deposit banks through the establishment, or acquisition, of subsidiary service companies. By the mid 1970s most deposit banks had a large number of subsidiary companies providing a wide range of financial services.[11] The use of conglomerate business structures subsequently spread from the deposit banks to the merchant banks,

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Banking Conglomerates: Revolution or Evolution? BARCLAYS BANK REV., Aug. 1985, at 56. For a U.S. perspective, see Cynthia C. Lichtenstein, *International Standards for Consolidated Supervision of Financial Conglomerates: Controlling Systemic Risk*, 19 BROOK. J. INTL LAW 137 (1993).

7. *See* MAYCOCK, *supra* note 6, at 2.

8. In connection with such single company service provision, one particular recent area of concern which has arisen in the United Kingdom is the abuse of trading privileges by market makers who are allowed to trade under cover on their own accounts in the U.K. markets. The Securities and Investments Board, which is responsible for the regulation of the provision of investment services in the United Kingdom under the Financial Services Act of 1986, recently completed an 18-month review into the privileges available to market makers on the London Stock Exchange following an earlier report of the Office of Fair Trading. *See* SECURITIES AND INVESTMENT BOARD, EQUITY MARKET REVIEW REPORT (June 21, 1995).

9. The specific difficulties which arise in connection with mixed conglomerates are discussed further below. *See* discussion *infra* part VI.E.2.n.

10. *See* MAYCOCK, *supra* note 6, at 2; *see also* CHARLES RAY, SLATER WALKER—AN INVESTIGATION OF A FINANCIAL PHENOMENON (1977).

11. *See* MAYCOCK, *supra* note 6, ch. 3.

discount houses,[12] savings institutions, securities houses, investment groups, and subsequently, to insurance companies.[13]

On the European continent, the development of financial conglomerates was not as spectacular since substantial market growth was possible through internal expansion on a Swiss/German universal banking model, which allows the provision of both commercial and investment banking services from within the same corporate unit.[14] Of more importance in terms of recent conglomerate development, however, has been the substantial increase in the number of Bancassurance or Bancaffianz groups,[15] especially in Germany and France.[16] These groups provide both banking and insurance services from within the same group, with the banking parent or subsidiary company, or companies, usually already providing commercial and investment banking services on the universal banking model.[17] Although this structure may initially only involve the sale of retail banking services combined with life assurance,[18] corporate investment banking as well as general insurance coverage may subsequently be developed subject to local regulatory restriction.[19]

During the 1980s and 1990s, conglomerate business structures grew substantially in Europe. This was possible through the deregulation of many domestic markets as well as with the general globalization of financial markets, which occurred as a result of the removal of many restrictions on the free movement of capital and improvements in telecommunications facilities and computer technology.

In the United States, the early development of financial conglomerates was

12. In the United Kingdom, a discount house is an agent bank of the Bank of England in the primary money market or discount market. *See* DAVID J. GOACHER, THE MONETARY AND FINANCIAL SYSTEM 67-70 (1990); PAUL HOWELLS & KEITH BAIN, FINANCIAL MARKETS AND INSTITUTIONS 94-102 (1990); JOHN GILBODY, THE UK MONETARY AND FINANCIAL SYSTEM 127-31 (1991).

13. *See* MAYCOCK, *supra* note 6, ch. 4.

14. In regulatory terms, a distinction has been drawn between institutional regulation on the European continent and functional regulation in the United Kingdom, which is more concerned with the type of financial service provided than the type of institution.

15. This is sometimes referred to as structural diffusion or structural arbitrage. The use of structural forms of control to limit loss in financial markets is discussed *infra* part V.

16. By June 1994, over 200 bank-assurance groups were estimated to exist within Europe. *See* Katherine Coates & Chris Ffinch, *A Single Passport for Insures—Where Next?*, EFSL, June 1994, at 49, 50.

17. *See generally* Philip Woolfson, *"Bancassurance" and Community Law: Current Status and Expected Developments*, 12 J. INT'L BUS. L. 519 (1994); Nicholas O'Niell, *Supervision of Financial Conglomerates*, 12 J. INT'L BUS. L. 235 (1994).

18. With regard to European practice, while the term *insurance* may be used to refer to life and nonlife (risk) cover, the term *assurance* is used to refer specifically to life insurance.

19. For a study into the measurement and assessment of the relative efficiency of banking and bancassurance strategies through financial ratio analysis and data envelopment analysis, see Margaret Brown & Edward P. Gardener, Bancassurance and European Banking Strategies: An Exploratory Analysis Using DEA of the Concept and Treatment of "Relative Efficiency" (Sept. 1994) (paper presented to the Annual Conference of the European Association of University Teachers in Banking and Finance, University of Modena, Italy).

limited due to restraints on branch banking, imposed under the McFadden Act of 1927, and more significantly with the functional separation of commercial banking and investment banking introduced under the Glass-Steagall provisions contained in the Banking Act of 1933.[20] Considerable business expansion was, however, subsequently possible, through the continued extension of national bank powers, and the use of bank holding companies[21] and their section 20 subsidiaries.[22] Expansion was also possible overseas, for example, through the use of Edge Act Corporations subject to the Federal Reserve Board's Regulation K.[23]

While many of the barriers imposed by the Glass-Steagall Act have been eroded through expansive interpretation of bank and bank holding company powers by federal regulators, the provisions still secure the fundamental separation of the commercial and investment banking industries in the United States.

Despite the Hunt Commission's investigation in 1970, significant legislative deregulation was not introduced at the federal level in the United States until the 1980 Depository Institutions Protection Act and the 1982 Garn-St Germain Depository Institutions Act.[24] Even then, progress was not substantial. Although there have been other proposals for the abolition, or at least revision, of the Glass-Steagall Act and of the more penal provisions of the Bank Holding Company Act, none has yet been successful. More substantial progress may, however, be

20. *See generally* James E. Smith, *Glass-Steagall Act—A History of Its Legislative Origins and Regulatory Construction*, 92 BANKING L.J. 38 (1975); Edwin J. Perkins, *The Divorce of Commercial and Investment Banking: A History*, 88 BANKING L.J. 483 (1971); H. Parker Willis, *The Banking Act of 1933 in Operation*, 35 COLUM. L. REV. 696 (1935); Roberta S. Karmel, *Glass-Steagall: Some Critical Reflections*, 97 BANKING L.J. 631 (1980). For more recent commentary, see generally Joseph J. Norton, *Up Against "the Wall": Glass-Steagall and the Dilemma of a Deregulated "Regulated" Banking Environment*, 42 BUS. LAW. 327 (1987); Keith R. Fisher, *Reviewing the Safety Net: Bank Diversification into Securities and Insurance Activities*, 27 WAKE FOREST L. REV. 123 (1992); George G. Kaufman & Larry R. Mate, *Glass-Steagall: Repeal by Regulatory and Judicial Reinterpretation*, 107 BANKING L.J. 388 (1990); Joseph J. Norton, Demise of the Glass-Steagall Act: A Study in Policy Indeterminates (Sept. 1995) (paper presented to the annual conference of the European Association of University Teachers in Banking and Finance, University of Valencia, Spain).

21. The Bank Holding Company Act of 1956 provided that the activity involved could be determined to be so closely related as to be a proper incident to banking and be reasonably expected to bring public benefits in the form of greater convenience, increased competition, or efficiency gains, which outweigh any possible adverse effects of undue concentration, decreased or unfair competition, conflicts of interest, or unsound banking practices. *See* JOSEPH J. NORTON & SHERRY C. WHITLEY, BANKING LAW MANUAL §§ 4.04, 4.07, 5.06 (1983 & Supp. 1995). Following the adoption of the Bank Holding Company Act, and after a slow initial development, by 1980, over 200 multibank holding companies had been established in the United States, in contrast to 2,426 one-bank holding companies. *See* MAYCOCK, *supra* note 6, at 37.

22. *See* NORTON & WHITLEY, *supra* note 21, § 4.04; *see also* Lichtenstein, *supra* note 6.

23. An "Edge Act" corporation is a federally chartered international banking or financial corporation set up under § 25(a) of the Federal Reserve Act of 1919 as amended, inter alia, by the 1978 International Banking Act. *See* NORTON & WHITLEY, *supra* note 21, § 15.03[1]-[9].

24. These measures facilitated, inter alia, greater equality between depository institutions and the granting of new powers to thrift institutions to compete with banks, as well as the cross-border acquisition of certain institutions experiencing difficulty.

possible under the provisions of the 1995 Financial Services Competitiveness Act, which is currently before the United States Congress.[25]

Although there have been regular calls for reform, special difficulties also remain with regard to the relationship between the banking and insurance industries in the United States.[26] Since the reversal of *Paul v. Virginia*[27] by the Supreme Court in *Southern-Eastern Underwriters Association* in 1944,[28] and the adoption of the McCarran-Ferguson Act in 1945, the insurance industry has been subject to strict regulation at the state level due to the threat of federal intervention in the event that such control was considered insufficiently effective.[29]

National banks and bank holding companies have also been restricted from acting as insurance agents, with the exception of national banks in small communities.[30] At the same time, bank holding companies are prohibited from owning substantial nonbank subsidiaries, unless properly incidental to their banking business and of sufficient public benefit.[31] Some significant recent developments in this area may, however, extend banks' powers in this regard.[32]

25. The Financial Services Competitiveness Act of 1995 was drafted by Congressman Jim Leach, chair of the U.S. House of Representatives Banking and Financial Services Committee, to end the separation of commercial and investment banking industries. Under this bill, bank and securities companies are to be allowed to own each other, subject to certain protections, although banks involved with government-insured deposits will have to use a holding company structure to establish effective firewalls between the banking and nonbanking risks. *See* George Graham, *Bank Reform Bill Gathers Wide Support*, FIN. TIMES, May 4, 1995, at 8. The bill was, however, incorporated into a larger regulatory reform measure in October 1995.

26. The House Banking Committee approved the controversial Baker Affiliation Amendment on June 28, 1995, by a 36-12 vote. This would allow national banks to affiliate with insurance companies in a holding company structure in states that permitted state-chartered banks to have insurance affiliates. Although Congressman Leach had attempted to exclude any extension of banks' powers to engage in insurance business from being included in the Financial Services Competitiveness Act, on June 28, 1995, concessions were accepted in connection with the moratorium on new bank insurance powers. *See* 65 Banking Rep. (BNA) No. 1, at 3 (July 3, 1995).

27. Paul v. Virginia, 231 U.S. 495 (1869).

28. United States v. Southern-Eastern Underwriters Ass'n, 322 U.S. 533 (1944).

29. Under the McCarran-Ferguson Act, Congress insisted that the regulation of the insurance industry was a matter for federal control, following the reversal of the decision in *Paul v. Virginia*, which had held that insurance was not interstate commerce. Under the Act, however, states were allowed to continue to regulate their own industries provided they did so effectively. *See* EMMETT J. VAUGHAN & CURTIS M. ELLIOTT, FUNDAMENTALS OF RISK AND INSURANCE ch. 10 (5th ed. 1989).

30. *See* NORTON & WHITLEY, *supra* note 21, § 4.07.

31. *Id.* § 4.07[2].

32. *See* American Land Title Ass'n v. Clarke, 968 F.2d 150 (2d Cir. 1992) (dealing with title insurance agency business); Independent Ins. Agents of Am., Inc. v. Ludwig, 997 F.2d 958 (D.C. Cir. 1993) (eliminating geographical limitations on the solicitation of insurance customers by national banks); Nationsbank of North Carolina, N.A. v. Variable Annuity Life Ins. Co., 115 S. Ct. 810 (1995) (authorizing national banks to sell fixed annuities). For comment, see Debra D. King, *Judicial Expansion of National Banks' Insurance Powers: The Resurrection and Statutory Interpretation of Section 92 of the National Bank Act*, 19 IOWA J. CORP. L. 833 (1994); Catherine E. Heigel, Case Comment, *Independent Insurance Agents of America, Inc. v. Ludwig and Variable Annuity Life Insurance Co. v. Clarke: The Banking-Insurance War in Search of a Judicial Truce*, 55 OHIO ST. L.J. 929 (1994).

Despite the current legislative proposals before Congress, the restrictive nature of the prohibitive or exclusionary formal regulatory climate in the United States clearly contrasts with the general global development of more integrated forms of business structures involving financial and mixed conglomerates, the growth of which clearly requires urgent regulatory attention.

Before considering the recent supervisory and regulatory developments that have occurred in this area, the basic advantages and corresponding risks that arise with regard to the use of conglomerate business structures in the financial services area are considered.

III. Conglomerate Advantage

Conglomerate structures have become important in terms of business strategy due to the significant improvements possible in terms of operational efficiency and effectiveness. These benefits arise from economies of scope and scale, which generate lower costs, reduced prices, and improved product and service innovation. At the same time, sector synergies can substantially increase the general competitiveness of the business. The stability of each of the structural components of a particular organization, as well as the business as a whole, can also be significantly improved through diversified revenues and risks. At the same time, product variety and innovation can increase customer loyalty as well as market penetration and market development.

Against the perceived benefits of conglomeration, however, must be set the possible dangers of resource depletion and concentration as well as new or aggravated forms of financial or legal risk, which arise especially with regard to the mixing of commercial and investment banking and banking and insurance services within a single business unit.

IV. Conglomerate Risk

A number of specific difficulties arise in connection with the use of conglomerate business structures, such as with regard to management autonomy, corporate transparency, and the control of conflicts of interest.[33] The most important issue that arises from a regulatory perspective, however, is the identification and control of the additional financial exposures created through this form of business.

These exposures are created from combining the traditionally separate market risks involved with banking, securities, and insurance activities, and, more specifically, from the creation of new relationships or dependencies between these traditionally distinct categories of risk, with the danger of contagion and possible systemic or market collapse then arising. Any new or aggravated forms of risk created by the use of conglomerates in national and international markets must,

33. *See infra* part VI.B.1.

therefore, be properly identified and assessed to allow appropriate corrective action to be taken.

Although the spread of financial exposure through contagion can occur in any distinct financial market, the most severe difficulties arise with regard to banks and other forms of depository and lending institutions. The basic difficulty which arises is that such institutions fund themselves short through the acceptance of retail or corporate deposits, often repayable on demand, or through short-term wholesale borrowing,[34] and then on-lend the repackaged funds to retail or corporate borrowers, on a medium- to long-term basis. The effect is to create an essentially illiquid asset base in the form of a portfolio of medium- to long-term loans through short-term borrowing. This mismatching of maturities[35] creates significant funding risks in the form of liquidity shortages which must be carefully managed by the institution.[36] At the same time, credit exposures are created on the asset side in the form of possible repayment default by one or more borrowers on their outstanding commitments.

An institution will always hold a certain amount of cash or other form of liquid assets to cover anticipated ongoing withdrawal demands.[37] Systemic dangers may still, however, arise from the possibility that unexpectedly large amounts of withdrawal requests may be made at any particular time, which liquidity shortages may be aggravated by outstanding credit defaults. Although the institution may still be technically solvent, it will not be able to meet withdrawal demands once the reserves have been exhausted, due to the fact that the largest part of the institution's asset base will be held in the form of illiquid loans. In such a case, the institution will have to borrow more funds from the wholesale markets although its ability to do so may have been adversely affected by a revised credit standing.

34. In the United Kingdom, short-term wholesale borrowing generally is effected through the Parallel or Secondary Money Markets, which comprise the Local Authority Market, the Finance House Market, the Inter-Company Market, the Sterling Inter-Bank Market, the Sterling CD Market, and the Sterling Commercial Paper Market. These markets developed in the late 1950s and 1960s following the closure of the Public Works Loan Account in 1958. The Secondary Money Markets in the United Kingdom have to be distinguished from the Primary or Discount Market in which the Bank of England acts as the United Kingdom's central bank through its agents, the discount houses, to adjust the volume of market liquidity on a daily basis. *See generally* GOACHER, *supra* note 12; HOWELLS & BAIN, *supra* note 12; GILBODY, *supra* note 12.

35. Maturity mismatching or maturity transformation is an integral part of the general process of financial intermediation. *See generally* HOWELLS & BAIN, *supra* note 12, ch. 3.

36. This is referred to as liability risk management in connection with the rolling over of short-term wholesale deposits although liquidity shortages may also clearly arise as a result of unexpected withdrawal demands; *see infra*.

37. This is traditionally referred to as fractional reserve banking, whereby a proportion or fraction of the institution's deposit base is held in reserve to cover anticipated withdrawal demands. The relevance of the phrase, however, is now less certain in light of the extensive credit facilities now available on modern inter-bank markets. Banks, accordingly, no longer have to be as concerned with the size of their underlying deposit base in light of the substantial amount of wholesale short-term funding available. To this extent, modern banking can be said to have moved from being deposit to asset driven, with the focus being on the development of a substantial asset portfolio rather than protection of its underlying deposit base.

Failing that, the institution will have to approach the relevant central bank for additional funding through its lender of last resort operations.[38]

The liquidity difficulties experienced by one institution may then be transferred to another, either through actual payment default by the first institution on its interbank commitments or through a separate run by depositors on the second institution. The stability of the market as a whole can then be threatened as the exposure spreads to other banking institutions. In the absence of central bank support, the result may be market or systemic collapse.

If a bank has to attempt to dispose of its loan portfolio, substantial losses on the nominal value of the loan book may be incurred since purchasing institutions will not be able to make the same credit assessment determinations as made by the disposing institution at the time the loan was originally authorized. As a result of this, the purchasing institution will insist on some level of discount.[39] To avoid such fire sales, regulators may attempt to secure a rescue of some form for a distressed institution, failing which, outstanding claims against the bank will be dealt with under the relevant deposit guarantee or insurance scheme or local insolvency law.[40]

Although the dangers of systemic collapse in modern financial markets are

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38. With regard to lender of last resort operations, a distinction can be drawn between a central bank's general responsibilities to monitor market liquidity for monetary policy purposes and its responsibility to assist individual institutions experiencing internal liquidity difficulties.

In terms of nineteenth century theory, the central bank would only assist an institution in difficulty in cases where the institution was illiquid but solvent in terms of its total asset base, unless the collapse of the particular institution would affect the stability of the market as a whole.

Financial support would, however, only be made available on a discretionary basis, to avoid moral hazard difficulties arising. With the removal of the possibility of financial loss, the credit managers of banks would undertake additional risks to generate further income. Shareholders, depositors, and other creditors will also have no incentive to exercise any form of control over the management of the business due to the removal of the risk of financial loss.

With regard to very large banks, this has led to the expression "too big to fail" in that due to their size it is assumed that the central bank would always have to support them to avoid market collapse. *See generally* HENRY THORNTON, AN ENQUIRY INTO THE NATURE AND EFFECTS OF THE PAPER CREDIT OF GREAT BRITAIN (1802); WALTER BAGEHOT, LOMBARD STREET (1873). *See also* Thomas M. Humphrey, *Lender of Last Resort: The Concept in History*, 75:2 FED. RESERVE BANK RICHMOND ECON. REV., Mar./Apr. 1989, at 8; CHARLES A.E. GOODHART, MONEY, INFORMATION AND UNCERTAINTY 176 (1989); LLEWELLYN, *supra* note 2.

Moral hazard difficulties also arise with regard to deposit protection or insurance schemes in that depositors, and possibly all other creditors, will again fail to exercise any control over the activities of a particular institution if the terms of the relevant protection scheme will always cover their losses. *See generally* IMF, THE EVOLVING ROLE OF CENTRAL BANKS pts. I, III (Patrick Downes & Reza Vaez-Zadeh eds., 1991); IMF, CURRENT LEGAL ISSUES AFFECTING CENTRAL BANKS (Robert C. Effros ed., 1992) [hereinafter CURRENT LEGAL ISSUES].

39. This may result in a fire sale where there is a substantial loss on the disposal of the loan book, although this may not necessarily be the case depending upon the quality of the specific assets held.

40. For a discussion of the historical background of purchase and assumption arrangements in the United States and the difficulties that arise with regard to full cover deposit protection, see Richard Dale, Deposit Insurance: Policy Clash over EC and US Reforms (1993) (Special Paper No. 53, on file with the London School of Economics Financial Markets Group). *See also* Dirk Schoenmaker,

considerably limited due to the sophisticated nature of the markets and the ability of central bank authorities to monitor and adjust market liquidity for general monetary policy and market stability purposes, a number of factors aggravate the risk of contagion and systemic collapse.[41] These factors include the higher levels of risk undertaken by financial institutions as national and international price competition places increasing pressure on profit margins; the greater interdependence created between separate national and financial markets through improvements in telecommunications, deregulation, and globalization of financial services; and the increasing levels of exposure created through developments in national and international payment and settlement systems.[42]

The use of the conglomerate structure itself may also increase both the internal and external risks of contagion. Due to the close relationships created between the distinct parts of the conglomerate, any loss or financial difficulty experienced by one component may be more easily transferred to other parts of the group. This transfer of exposure may arise, for example, through direct intra-group loans or payment arrangements or cross-shareholdings, or simply as a result of damaged confidence being transferred by the market to other parts of the group.[43]

More importantly, the risk of contagion is also created between different financial sectors as loss in one traditionally distinct market may be transferred to a separate market in which the same conglomerate is involved. The creation of the risk of market instability through loss transference within a single group is possibly the most significant danger created by the use of conglomerate forms of business.[44]

Home Country Deposit Insurance (1992) (Special Paper No. 43, on file with the London School of Economics Financial Markets Group); EDWARD J. KANE, THE GATHERING CRISIS IN FEDERAL DEPOSIT INSURANCE (1985).

41. In connection with whether markets are inherently stable or unstable, see Hyman P. Minsky, *A Theory of Systemic Fragility in* FINANCIAL CRISES: INSTITUTIONS AND MARKETS IN A FRAGILE ENVIRONMENT (Edward L. Altman & Arnold W. Sametz eds., 1977); CHARLES P. KINDLEBERGER, MANIAS, PANICS AND CRASHES: A HISTORY OF FINANCIAL CRISES (1978); EDWARD P. DAVIS, DEBT, FINANCIAL FRAGILITY AND SYSTEMIC RISK (1992).

42. In connection with the general systemic dangers involved in payment systems and the move towards real-time gross settlement in Europe, see generally *Developments in Wholesale Payment Systems*, 32 BANK ENG. Q. BULL. 449 (1992); Dirk Schoenmaker, Externalities in Payment Systems: Issues for Europe (Sept. 1993) (Special Paper, on file with the London School of Economics Financial Markets Group); Brian Quinn, *The UK approach to controlling risk in large-value payment systems*, 33 BANK ENG. Q. BULL. 530 (1993); *The Development of a real-time gross settlement system*, 34 BANK ENG. Q. BULL. 163 (1994). *See also* BANK FOR INTERNATIONAL SETTLEMENTS (BIS), LARGE VALUE FUNDS TRANSFER SYSTEMS IN THE GROUP OF TEN COUNTRIES (1992); EUROPEAN COMMISSION, EASIER CROSS-BORDER PAYMENTS: BREAKING DOWN THE BARRIERS (1992); AD HOC WORKING GROUP ON EC PAYMENT SYSTEMS, EUROPEAN COMMUNITY ISSUES OF COMMON CONCERN TO EC CENTRAL BANKS IN THE FIELD OF PAYMENT SYSTEMS (1992); AD HOC WORKING GROUP ON EC PAYMENT SYSTEMS, EUROPEAN COMMUNITY PAYMENT SYSTEMS IN EC MEMBER STATES (1992); C.E.V. BORIO ET AL., THE NATURE AND MANAGEMENT OF PAYMENT SYSTEM RISKS (1993).

43. *See infra* parts VI.B.2.a. and VI.E.2.c.

44. *See generally* Richard Dale, *Regulating Investment Business in the Single Market*, 34 BANK ENG. Q. BULL. 333 (1994); Richard Dale, *Regulating Banks' Securities Activities: A Global Assessment*, 1991 J. INT'L SEC. MARKETS 277, 286.

In contrast with banking markets, securities markets are not subject to the same inherent dangers of systemic collapse due to the absence of maturity mismatching, in particular, as they will generally fund their trading activities through the issuance of short-term subordinated debt which may often be secured.[45] Difficulties can still arise, however, for example, where a securities house has a large portfolio of securities or a number of open positions which may be difficult to dispose of, or close quickly, or as a result of settlement system failures.[46]

While banking essentially involves the development and management of a portfolio of illiquid loans, with earnings arising from the difference in the interest rate paid to depositors and that charged to borrowers, securities activities involve the underwriting and disposal, or purchase and sale, of essentially liquid securities through the various primary and secondary trading markets available.[47] Earnings are generated from the difference in the price at which the security is bought and sold, as well as through additional underwriting and other ancillary advisory or service fees. In terms of operational risks, investment houses are subject to market or position risk, that is, adverse movements in the price of the security,[48] which may be linked to some currency or interest rate movements, as well as counterparty or settlement risk, where dealings are carried out on a market in which delivery and payment operations are separated.[49]

In the event of a liquidity shortage, however, a securities house can either borrow more, such as through the issuance of additional short-term subordinated debt, although then possibly only at a higher rate, or dispose of assets. As the assets, in this case, will largely comprise tradable securities, only limited loss

45. Subordinated debt is generally treated more favorably for capital adequacy purposes in relation to securities business than banking business. Under modern capital requirements securitized funding is, accordingly, cheaper than a traditional bank loan. For a critical examination of the European developments in this area, see RICHARD DALE, INTERNATIONAL BANKING DEREGULATION: THE GREAT BANKING EXPERIMENT (1992).

46. For a general discussion of the systemic issues involved with securities markets, see OECD, SYSTEMIC RISKS IN SECURITIES MARKETS (1991). For comment, see Lichtenstein, *supra* note 6, at 140. *See also* Richard L. Fogel, *Stability of Financial Markets: Federal Reserve Responsibility? in* 1 CURRENT LEGAL ISSUES, *supra* note 38, ch. 15, at 317; Bevis Longstreth, *Averting a Chain Reaction Disaster in the Money World*, BUS. & SOC'Y REV., Summer 1983, at 32; Dale, *supra* note 44 (both articles). In connection with clearance and settlement difficulties in securities markets, see generally GROUP OF THIRTY (G 30), CLEARANCE AND SETTLEMENT SYSTEMS IN THE WORLD'S SECURITIES MARKETS (1989) and COMMITTEE ON PAYMENT AND SETTLEMENT SYSTEMS, DELIVERY VERSUS PAYMENT IN SECURITIES SETTLEMENT SYSTEMS (1992). In connection with the October 1987 Crash and the systemic issues raised in connection with the relationship between security markets and the financial system as a whole, see STEVEN SOLOMON, THE CONFIDENCE GAME: HOW UNELECTED CENTRAL BANKERS ARE GOVERNING THE CHANGED WORLD ECONOMY pt. I (1995).

47. In securities terms, a primary market refers to the original market of issuance or placement, while the secondary market refers to the market on which the securities are subsequently traded.

48. Adverse currency or interest rate exposure is separately assessed for modern capital adequacy purposes. *See* ALLAN MURRAY-JONES & ANDREW GAMBLE, MANAGING CAPITAL ADEQUACY: A HANDBOOK OF INTERNATIONAL REGULATIONS ch. 9 (1991).

49. The risk is that a counterparty may fail to deliver title or make payment on settlement of an earlier contract. For example, dealings on the London Stock Exchange are settled after five days.

should be incurred on their sale in contrast with the fire sale of a bank's loan book. Even in the event of a serious shortfall, however, with the segregation of client money and securities, the firm should be able to wind up its business through the disposal of its whole portfolio within a short period, with losses being limited, in the absence of fraud, and then generally borne only by the company's shareholders.

Distinct difficulties again, however, arise with regard to insurance business. In this case, the basic regulatory concern is not with regard to credit default by medium- to long-term borrowers or by adverse fluctuations in market prices, but with the long-term stability of the fund to ensure that all ongoing payment commitments can be made.[50] Although income generation is dependent on the value of the investment portfolio, which is subject to a certain amount of market risk, the degree of risk is less than that associated with securities businesses. The highly regulated nature of the insurance industry, which will, in particular, include composition rules, ensures that the bulk of the portfolio is made up of relatively safe assets, such as local government[51] or other fixed-interest debt, which provides a more stable, but not as high yielding, return.[52]

In terms of regulatory practice, insurance undertakings will also be required to maintain a sufficient level of technical reserves to cover all outstanding underwriting commitments, as well as separate solvency margins to cover short-term fluctuations in asset values and trading losses. Local asset matching requirements also may be imposed to ensure that a particular branch, or overseas operation, has sufficient realizable assets to cover local payment demands.

The justification for the imposition of reserve and solvency requirements, in addition to composition rules, is that insurance companies may not otherwise hold appropriate or sufficient levels of assets to cover commitments. Although premiums are paid in advance by policyholders, performance under the relevant contracts will not be required until a specified future date or only in the event that a certain stated contingency arises.

The purpose of insurance regulation is, accordingly, to protect the value of the fund against dilution, for example, through competition in premium pricing or the failure to maintain sufficient asset cover, so that required contractual payments can, at all times, be made by the regulated undertaking.[53]

50. Difficulties may, however, arise with regards to the need to deal with the long-term information asymmetries involved in monitoring the value of the fund and with the need to secure proper contractual performance at the end of the investment period.

51. An important aspect of insurance and banking market regulation historically has been the use by central banks of regulatory controls for the purpose of securing domestic monetary policy objectives rather than for clearly established regulatory purposes. One example would be the maintenance of a sound market in local government debt.

52. For a comprehensive treatment of national insurance systems and the transnational issues that arise, see INTERNATIONAL INSURANCE LAW AND REGULATION (Dennis Campbell ed., 1994).

53. *See generally* JORG FINSINGER & MARK PAULY, THE ECONOMICS OF INSURANCE REGULATION: A CROSS-NATIONAL STUDY (1986); VAUGHAN & ELLIOTT, *supra* note 29, ch. 10.

In light of the very basic differences that exist between the principal financial services markets, although securities and insurance markets are subject to significant but distinct operational risks, they are not inherently subject to the same dangers of systemic collapse, as banking markets, due to the absence of maturity mismatches. The serious danger that remains with regard to the use of conglomerate forms of business, however, is that trading losses incurred on securities markets may be more easily transferred to the banking markets, with the significant destabilizing effects which that could have on national and international markets generally.[54] Substantial securities losses could, in particular, arise from trading on more speculative or volatile foreign currency and derivatives markets.[55]

The danger of loss transfer may be particularly acute where bank deposits have been used to support securities losses for a period before the collapse, as in the case of Barings,[56] or where the availability of public support for the banking operations has created serious moral hazard difficulties in the management of the securities business.

A similar difficulty may, of course, also arise where losses are transferred to the insurance markets, which may have a detrimental effect on the solvency of a particular fund or funds, and consequential long-term social and welfare damage.

V. Structural Regulation

One solution to the difficulties created by the risk of loss transfer between separate financial markets is through the use of separation rules or structural regulation at the authorization stage. In terms of separation options, the most extreme form of regulation available is the Glass-Steagall model, as originally developed in the United States[57] and subsequently introduced into Japan.[58] This

54. *See supra* note 38.

55. In connection with the regulatory difficulties which arise with regard to modern derivatives trading, see generally BASLE COMMITTEE ON BANKING SUPERVISION (BASLE COMMITTEE), THE MANAGEMENT OF BANKS' OFF-BALANCE SHEET EXPOSURE: A SUPERVISORY PERSPECTIVE (1986); BIS, RECENT INNOVATIONS IN INTERNATIONAL BANKING (1986) ("the Cross Report"); BIS, RECENT DEVELOPMENTS IN INTERNATIONAL INTERBANK RELATIONS (1992) ("the Promisel Report"); G 30, REPORT ON DERIVATIVES (1993); BANK OF ENGLAND, DERIVATIVES: REPORT OF AN INTERNAL WORKING GROUP (1993); BASLE COMMITTEE, PRUDENTIAL SUPERVISION OF BANKS' DERIVATIVES ACTIVITIES (1994); BASLE COMMITTEE & TECHNICAL COMMITTEE, INTERNATIONAL ORGANISATION OF SECURITIES COMMISSIONS [IOSCO], FRAMEWORK FOR SUPERVISORY INFORMATION ABOUT THE DERIVATIVES ACTIVITIES OF BANKS AND SECURITIES FIRMS (1995). The Basle Committee on Banking Supervision was formerly known as the Basle Committee on Banking Regulation and Supervisory Practice or, more informally, "the Cooke Committee," after its then chairman.

56. Regarding the collapse of Barings, see BANK OF ENGLAND, *supra* note 4.

57. For a critical analysis of the effectiveness of the Glass-Steagall system, see DALE, *supra* note 45.

58. *See generally* MAXMILLIAN J.B. HALL, BANKING REGULATION AND SUPERVISION: A COMPARATIVE STUDY OF THE UK, USA AND JAPAN (1993); Richard Dale, *Japan's "Glass-Steagall" Act*, 3 J. INT'L BANKING L. 138, 138-46 (1987).

involves prohibiting banks from undertaking securities business, or owning securities firms. Intermediate options include the use of financial holding companies or separately capitalized securities subsidiaries with appropriate financial firewalls to prevent risk transfer.[59]

At the other regulatory extreme is the universal banking model, which allows banks to engage fully in banking and securities activities.[60] To deal with the additional financial exposure created, capital adjustment mechanisms can be used to ensure that sufficient capital is available to cover all of the risks involved. In this case, however, the capital mechanisms act by way of loss absorption rather than through the restriction on loss transfer.

In Europe, risk separation between commercial and investment banking is dealt with by distinguishing a bank's loan book from its securities or trading book, in connection with which separate capital requirements are imposed.[61] This is extended to the group level by the requirement that consolidated accounts be prepared for all banking and investment groups with further capital adjustments being imposed to prevent abuse, such as through deduction of interests in other financial companies in the calculation of adequate own funds, which serves, in particular, to prevent double-gearing.[62]

With regards to the insurance industry, structural regulation is also generally imposed on insurance companies at the authorization stage to prohibit them from undertaking any other substantial types of business, although this may not be extended to include restrictions on controlling interests or subsidiary operations. One example of structural regulation in the insurance industry is the prohibition on composite insurance, which involves the provision of life and nonlife coverage by the same company, although any difficulties which may arise can be dealt with through the maintenance of separate accounts and solvency margins.[63] Another more specific example is the restriction of cumul, which arises when an insurer can cover a particular risk either through a place of establishment in a particular country, or on a cross-border basis, from another territory.[64]

In light of the different approaches adopted with regards to structural regulation and of the distinct treatment of risk in each of the separate financial markets involved, considerable difficulties will arise in attempting to develop common rules, or guidelines, for the supervision of financial conglomerates at the international level. Each distinct set of national law and supporting regulatory practice

59. *See supra* notes 21, 22.

60. *See supra* part II.

61. *See* the Capital Adequacy Directive, *infra* note 169.

62. *See* the Own Funds Directive, *infra* note 166.

63. In Europe the establishment of new composites was prohibited under the early life insurance directives, although these restrictions were subsequently removed following an investigation by the European Commission into the relative performance of composite insurers and those providing only life business. *See* NICHOLAS PAUL & RICHARD CROLY, EC INSURANCE LAW para. 7.19 (1991).

64. *See id.* paras. 4.19-.22.

will have to be examined in an attempt to arrive at common agreement on the relevant requirements.

Where it is not possible to agree on a particular set of provisions on specific matters in light of the basic differences which arise with regard to market structure and national practice, a mixture of harmonized rules and supervisory or regulatory options will have to be developed which are capable of general acceptance and which can secure a sufficient degree of equivalence in terms of risk identification and protection.

The most important international and European developments in this area are reviewed in the following sections.

VI. International Regulatory Responses

The main work produced, to date, concerning the development of global responses to the difficulties created by the supervision and regulation of financial conglomerates has been undertaken by the Basle Committee[65] and IOSCO.[66]

Although the Basle Committee has been developing general principles for the supervision of international financial institutions and financial groups on a consolidated basis,[67] and convergence standards in respect of bank capital,[68] since its establishment in 1974, the Committee has also become concerned more recently with the specific difficulties created by the development of financial and mixed-activity conglomerates.[69] In light of the special difficulties which arise,

65. *See supra* note 55. *See generally* C.J. Thompson, *The Basle Concordat: International Collaboration in Banking Supervision, in* 1 CURRENT LEGAL ISSUES, *supra* note 38, ch. 16, at 331; Charles Freeland, *The Work of the Basle Committee, in* CURRENT LEGAL ISSUES, *supra* note 38, ch. 19, at 231.

66. *See supra* note 55; IOSCO, PRINCIPLES FOR THE SUPERVISION OF FINANCIAL CONGLOMERATES (Dec. 7, 1992). This Report was presented at the 17th Annual Conference in London in October 1992.

67. The Basle Committee's early recommendations with regard to the development of effective supervisory techniques in connection with the overseas activities of international banks and, in particular, with the allocation of appropriate supervisory responsibilities were set out in the 1975 First Concordat. *See* BASLE COMMITTEE, REPORT TO THE GOVERNORS ON THE SUPERVISION OF BANKS' FOREIGN ESTABLISHMENTS (1975). A revised Concordat was subsequently issued in 1983 following an earlier paper in October 1978 recommending that supervision be conducted on the basis of the consolidated balance sheet of all an international bank's constituent entities. *See* BASLE COMMITTEE, REVISED BASLE CONCORDAT ON PRINCIPLES FOR THE SUPERVISION OF BANKS' FOREIGN ESTABLISHMENTS (1983); BASLE COMMITTEE, CONSOLIDATION OF BANKS' BALANCE SHEETS: AGGREGATION OF RISK-BEARING ASSETS AS A METHOD OF SUPERVISORY BANK SOLVENCY (Oct. 1978). A supplement to the revised Concordat was issued in 1990. *See* BASLE COMMITTEE, REPORT ON INTERNATIONAL DEVELOPMENTS IN BANKING SUPERVISION (1990). This supplement was followed by a restatement of the Minimum Standards for Supervision in 1992. *See* BASLE COMMITTEE, REPORT ON INTERNATIONAL DEVELOPMENTS IN BANKING SUPERVISION ch. VI (1992) [hereinafter 1992 REPORT]. A collection of confidential responses from national supervisors to questionnaires issued by the Committee was also prepared in 1984, although this was not subsequently made available to the general public.

68. BASLE COMMITTEE, REPORT ON INTERNATIONAL CONVERGENCE OF CAPITAL, MEASUREMENT AND CAPITAL STANDARDS (1988).

69. *See infra* part VI.B.

the Basle Committee established a multidisciplinary working group, made up of regulators from each of the three principal supervisory areas involved, to examine the feasibility of developing general principles for the supervision of financial conglomerates.[70] This working group subsequently became known as the Tripartite Group of Banking, Insurance and Securities Regulators.[71]

In connection with this work, the Basle Committee set out a series of general principles for the supervision of financial conglomerates for examination by the Tripartite Group, which principles were reprinted in the Committee's 1992 Report on International Developments in Banking Supervision.[72] The Tripartite Group subsequently issued a progress report in 1994[73] with a final report being published in July 1995.[74]

One month after the Basle Committee published its general principles in September 1992, IOSCO issued its Report on the Supervision of Conglomerates.[75]

The principal conclusions and recommendations of each of these reports are outlined below. This is followed by a review of the recent measures proposed in Europe to deal with the difficulties identified.

A. Basle Committee—Minimum Standards for the Supervision of International Banking Groups, September 1992

The basic rules with regard to the supervision of international banks and international banking groups, which include the component parts of any financial or mixed conglomerate, are presently set out in the Basle Minimum Standards for the Supervision of International Banking Groups and their Cross-Border Establishments.[76]

The Minimum Standards followed a review of international supervisory coordination undertaken in the summer of 1992 following, in particular, the collapse of BCCI[77] and such other developments as the events that occurred in the Atlanta branch of the Banca Nazionale del Lavoro.[78] Although the Committee concluded that the revised 1983 Concordat,[79] and the 1990 Supple-

70. Although the work was to be carried out by the special multidisciplinary working group set up by the Basle Committee, the group would have access to the work being carried out on the subject by such other international institutions as IOSCO and in the European Community. 1992 REPORT, *supra* note 67, at 59.

71. *See infra* parts VI.D. and VI.E.

72. 1992 REPORT, *supra* note 67, ch. III.

73. *See infra* part VI.D. The interim Report is reprinted in 1992 REPORT, *supra* note 67, ch. VII.

74. *See infra* Part VI.E.

75. IOSCO, *supra* note 66; *see infra* part VI.C.

76. BASLE COMMITTEE, MINIMUM STANDARDS FOR THE SUPERVISION OF INTERNATIONAL BANKING GROUPS AND THEIR CROSS-BORDER ESTABLISHMENTS (1992), *reprinted in* 1992 REPORT, *supra* note 67, ch. III.

77. *See supra* note 67; *see also supra* note 4.

78. 1992 REPORT, *supra* note 67, at 10.

79. *See id.*

ment,[80] were soundly based, it was concerned that supervisory authorities had to strengthen their commitment to implement the best-efforts character of the principles established.[81]

Accordingly, the Committee recommended that certain minimum standards for supervision be established and that all Group of Ten authorities should be expected to observe them and, at the same time, urge other supervisory authorities throughout the world to adhere to the new minimum standards.

The Minimum Standards established are as follows:[82]

(1) all international banking groups and international banks should be supervised by a home-country authority that capably performs consolidated supervision;

(2) the creation of a cross-border banking establishment should receive the prior consent of both the host-country supervisory authority and the supervisory authority of the bank and, if different, the banking group's home-country supervisory authority;

(3) supervisory authorities should possess the right to gather information from the cross-border banking establishments of the banks, or banking groups, for which they are the home-country supervisor; and

(4) if a host-country authority should determine that any one of the foregoing minimum standards is not being met to its satisfaction, that authority should impose restrictive measures necessary to satisfy its prudential concerns consistent with these minimum standards, including, if necessary, prohibition of the creation of banking establishments in the particular territory concerned.

These Minimum Standards, with the minimum capital requirements set out in the Basle Capital Accord,[83] as amended with regards to bilateral netting and country transfer risks and market risk,[84] constitute the basic rules presently applicable to the supervision of the banking components of any national or international business conglomerates.

B. Basle Committee—Principles for the Supervision of Financial Conglomerates, September 1992

General principles for the supervision of financial conglomerates were set out in the 1992 Report on International Banking Supervision (1992 Report). The stated purpose was to establish certain principles which the main supervisors of financial institutions in the Group of Ten countries believed should govern the

80. *See id.*

81. *Id.*

82. The detailed requirements involved with each of the minimum standards are expanded in the text. *See id.* at 11-18.

83. Basle Committee, *supra* note 68. For a recent note of the amendments to be made to the original capital accord, see Basle Committee, Report on International Developments in Banking Supervision chs. VIII, IX (1994) [hereinafter 1994 Report].

84. *See id.* ch. VIII.

supervision of international groups which included business activities subject to more than one supervisory authority, with the specific emphasis of the paper being the prudential conduct and soundness of such groups.[85]

Although the principles developed were not necessarily to be given specific legal or regulatory effect in the countries involved, they were recommended as principles of general practice which authorities should follow to the extent that they were able. Where this was not possible, authorities were expected to modify their arrangements to enable adherence with the relevant principles. Where situations arose not covered by the principles stated in the paper, the authorities concerned were required to consult with each other to agree on a basis to secure the adequate supervision of the institutions involved.[86]

The principles were generally concerned with financial conglomerates, although it is stated that they could equally be applied to the supervision of mixed conglomerates comprising any group of companies whose activities largely consisted of providing financial services in different sectors, but which may also have some commercial or industrial interests.

Although the principles were designed to deal with the difficulties created by groups subject to supervision in more than one country, the principles were equally applicable to groups carrying on business in a single state.

The 1992 Report lists a number of specific difficulties which arise in connection with the supervision of financial conglomerates and sets out a corresponding set of general principles of supervision with some additional notes on the methods of supervision.

1. *Conglomerate Supervision Difficulties*

Although the advantages of asset, risk, and sources of earnings diversification in conglomerate structures are recognized, it is noted that a number of additional supervisory difficulties may arise with regard to contagion, double-gearing, risk mixing, intragroup exposures, conflicts of interest, management authority, dispersion of control, and transparency.[87] Each of these issues is discussed in turn below.

a. Contagion

Capital shortages and confidence damage may be caused in parts of the group through activities of supervised or unsupervised entities in other parts.

b. Double-Gearing

The sum of the regulated component capital requirements may not be covered by the total group capital through double-gearing while capital weaknesses may be created through quality dilution, for example, the downstreaming of subordinated debt through equity participations.

85. *Id.* at 59.
86. *Id.* at 60.
87. *Id.* at 61-63.

c. Risk Mixing

Management and control procedures may be of insufficient quality to meet the demands of the more complex risk management necessary to obtain the advantages of the services synergy available with the conglomerate structure. Management weaknesses may, in particular, result in the continuation of losses in one part of the group being subsidized by profits elsewhere.

d. Intra-Group Exposures

Contagion difficulties are significantly exacerbated through complex intragroup exposures. Such exposures may create a web of direct and indirect claims through credit lines, equity investments, trading exposures, liquidity management, guarantees, and commodities.

e. Conflicts of Interest

Serious conflicts of interest may arise when a banking group acts for customers in different capacities through the provision of a range of different services, and where substantial investors in the group, or its affiliates, are also customers of the group in one capacity or another. Although the difficulties created can be dealt with by Chinese Walls, it is noted that these may not prevent the reputation of the group as a whole suffering damage and may break down if put under pressure.

f. Management Authority

Although the benefits of conglomeration require central management, supervisors of the component parts of the operation must be satisfied that adequate management is exercised at the regulated level.

g. Dispersion of Control

Loosely structured conglomerates may result in the decentralization of control, which obstructs effective supervision as well as possibly accentuating conflict-of-interest problems.

h. Transparency

Conglomerate structures must be transparent to ensure that the totality of risk involved can be properly assessed, although increasing difficulties arise through the separation of the legal structure from the business structure for tax and regulatory purposes.

2. *Principles of Supervision*

Although it is noted that the structures of financial conglomerates are extremely varied and continuously changing, certain general principles can be developed for application in each individual case.[88]

88. *Id.* at 63-67.

a. Ambit of Supervision

In situations in which the conglomerate is headed by a supervised institution, or a financial holding company on the U.S. bank holding company model, supervision should be carried out on a group-wide basis from the top down. Where the parent company is not supervised, any parallel financial companies must be treated on a group-wide basis, with the supervisor always ensuring that all risks are adequately assessed.

Where a group includes substantial nonfinancial activities, supervisors should ensure an extra measure of prudence within the supervised institutions. If these interests are material, however, it is recognized that supervisors can do little to prevent the possible risk of contagion.[89]

b. Information and Consolidation

Supervisors should have access to information about the complete range of risks carried on by each of the financial components in the group. Although this information is most easily available from the parent holding company, if access to the parent company is not possible, the information must be obtained from the supervised entity.

Some form of consolidated supervision should be effected by the supervisor responsible for the parent company or the major operating entity, although a more qualitative assessment of the group should be effected beyond a simple accounting consolidation, which may distort the true level of risk present due to the different accounting principles applicable to the separate activities involved. As the distinctions between different types of financial intermediation break down, a more qualitatively based assessment is necessary to ensure that all risks present in the group are taken into account.

c. Capital Strength

The capital base of the parent company within a group should be at least as large as the sum of the capital required by the supervisors and regulators of each of the operating companies involved together with the capital employed in any unregulated subsidiaries in cases both where the parent is a substantial financial institution and where the parent is only a holding company with the operations of the group being undertaken through subsidiaries.

The quality of the parent company's capital should also be as good, or better, than that of each of the operating companies, although some minor dilution may be acceptable provided that it is only equal to a small proportion of total group capital.

Capital must also be well distributed within the group, with each operating

89. Problems arise with regard to mixed-activity groups as only authorized institutions can be supervised and sanctioned, while any attempt by supervisors to exercise any authority over the nonfinancial element creates the risk of moral hazard to the extent that the public may assume that the whole group is then subject to complete supervision.

company being adequately capitalized in accordance with the relevant regulatory provisions, although the group structure must not allow the same capital to be used more than once.[90]

d. Organization

The structure of the conglomerate must be coherent and transparent to supervisors and regulators, as well as to creditors and other customers, with supervisors having powers to prohibit obstructive corporate structures and to direct the location of the place of business of the parent company and principal operating subsidiaries.

If the conglomerate includes commercial, industrial, or other activities unrelated to the supervised activity, it is recommended that the financial activities be placed in a self-contained subgroup to facilitate supervision on a consolidated basis.

e. Ownership

The fitness and properness of shareholders should be vetted to prevent conflicts from arising between the interests of shareholders and other creditors such as investors, depositors, and policyholders. While shareholders will be concerned with ensuring that their capital is properly rewarded, they must also act responsibly with regard to other group creditors.

f. Risk Control

Adequate control mechanisms must be in place throughout the group, and information accurately processed in order to ensure that all group risks are properly monitored, especially with regard to large credit and market risk exposures. Adequate arrangements must also exist to monitor and control liquidity on a group basis.

g. Connected Transactions

Intra-group credit lines[91] and other forms of connected payments, such as abnormal service fees or dividend payments, must be carefully monitored to ensure that regulated entities are not "milked" by nonfinancial members of the group. Although consolidation is effective in assessing external risks, it may conceal dangerous intra-group imbalances. Supervisors must, accordingly, carefully monitor unusual intra-group transactions as well as all forms of connected lending.

90. The difficulties which arise in connection with capital adequacy in conglomerates are considered in much greater detail in the final Report of the Tripartite Group of Banking, Securities and Insurance Regulators of July 1995. *See infra* part VI.E.

91. For example, a banking subsidiary may lend to a nonbank parent, or an unsupervised entity, without complying with the normal credit assessment procedures.

h. Management

Supervisors and regulators must make certain that regulated and nonregulated holding companies have adequate strength of management to ensure that total group risk is prudently managed. All managers directly or indirectly capable of influencing the supervised components within the group must be qualified as fit and proper and have adequate authority to respond to the demands of supervisors acting on behalf of depositors, investors, and policyholders.

i. External Audit

While it is recognized that the appointment of a single audit firm may ensure that an independent overall view of the group is obtained, a local auditor with specialized knowledge of individual group activities may also have an important role to play in the supervisory process.

3. *Methods of Supervision*

In a particular case, distinct methods of supervision will be adopted to give effect to the principles set out above although these methods should normally include each of the following components.

a. Cooperation

Authorities must cooperate to ensure the effective supervision of groups made up of distinct entities subject to supervisors and regulators from more than one discipline and in more than one country. For this reason, authorities must have adequate powers to share prudential information, especially with regard to intra-group exposures.[92]

b. Lead Supervisors or Regulators

Where possible, a convener should be appointed to ensure that all authorities are properly furnished with all appropriate information. The convener should usually be the supervisor of the dominant business within the group.

c. Individual Supervisor

It is recommended that one supervisory authority should exercise overall responsibility for the whole group. Where the parent company is a supervised entity, the other supervisors involved may, however, not be able to surrender their functions in all cases, and may need to retain separate responsibility in connection with the activities of the group component within their jurisdiction. To the extent possible, however, supervisory action should be taken in cooperation with the other authorities involved.

92. *See* BASLE COMMITTEE, SUPPLEMENT TO THE BASLE CONCORDAT ON THE ENSURING OF ADEQUATE INFORMATION FLOWS BETWEEN SUPERVISORY AUTHORITIES (1990), circulated to banking, securities, and insurance supervisory authorities worldwide.

C. IOSCO Technical Committee—Principles for the Supervision of Financial Conglomerates, November 1992

The Technical Committee of IOSCO issued its Report on the Principles for the Supervision of Financial Conglomerates at its 17th Annual Conference in London in October 1992. The purpose of the Technical Committee's report was to establish general principles to form the basis for the risk assessment of financial conglomerates which could be used, as far as possible, to guide the development of regulatory practice and regulatory cooperation in the area.[93] The Technical Committee, however, noted that although the principles were relevant to the question of conglomerate supervision generally, the main concern of the Committee was with groups in which securities business played a significant part.[94]

The Technical Committee made the following principal recommendations:

(1) risk assessment should be group-based if the regulated firm that is part of the financial conglomerate is vulnerable to the risk of contagion;[95]

(2) amounts counted towards regulatory capital should be controlled by appropriate regulations including, in particular, appropriate deductions to avoid double-gearing;[96]

(3) the effective risk assessment of financial conglomerates requires careful monitoring of intra-group exposures and, where necessary, limits on such exposures in the regulated entity;[97]

(4) corporate and managerial structures of the financial conglomerate should be fully understood by the regulator;[98]

(5) regulators should seek, insofar as possible, to identify shareholders with such a stake in the conglomerate as would enable them to exert material influence on the activities of the entity;[99]

(6) appropriate regulatory standards should be established for managers of a regulated entity;[100]

93. IOSCO, *supra* note 66, at 10.

94. *Id.* at 3.

95. *Id.* at 11. The effect is to support the traditional approach of securities regulators to the prudential regulation of securities firms on a solo as opposed to consolidated basis, although this is to be complemented through an assessment of the risk the rest of the financial conglomerate creates for the regulated securities firm. The Introduction to the Principles notes that even where the failure of a regulated securities firm is unlikely to have serious consequences for the securities industry and the financial system generally, the risk of contagion means that it is highly desirable for the securities regulator to have early warning of problems elsewhere in the group. *Id.* at 8. For comment on the extent to which this supports the SEC's Temporary Risk Assessment Rules under the Market Reform Act in place of the BHCA approach, see Lichtenstein, *supra* note 6, at 155.

96. IOSCO, *supra* note 66, at 17.

97. *Id.* at 20. In connection with the response of the European Community, see the Large Exposures Directive, 1992 O.J. (L 29) 1.

98. IOSCO, *supra* note 64, at 21.

99. *Id.* at 22.

100. *Id.* at 23.

(7) every effort should be made to promote supervisory cooperation and to appoint a lead regulator where the activities of a group involve more than one regulatory authority;[101] and
(8) regulators should recognize the importance of the role of external auditors and the possible contribution that they may make to group-based risk assessment.[102]

The IOSCO Principles, although more limited in scope and content than the Basle Principles for the Supervision of Financial Conglomerates, reflect the general content of a number of the Basle proposals. It is significant, however, that the IOSCO recommendations support the continuation of a solo rather than a consolidated approach to supervision, which reflects the present North American style of securities supervision.[103]

D. Tripartite Group of Banking, Insurance and Securities Regulators—Progress Report on the Supervision of Financial Conglomerates, April 1994

Following the issuance of the 1992 Basle Report,[104] the Tripartite Group of Banking, Insurance and Securities Regulators met for the first time in February 1993.[105] A progress report was produced in April 1994 and sent to the Basle Committee, to IOSCO, and to the heads of insurance supervisory authorities in the Group of Ten countries.[106] A technical subgroup was also established to examine in further detail issues related to the overall assessment of capital adequacy in financial conglomerates, although the results of this examination were not made publicly available.[107]

In the Progress Report, the Tripartite Group made a number of recommendations with regard to supervisory approaches, cooperation, capital adequacy, structure, ownership and management, contagion, external auditors, and supervisory arbitrage.[108] Although the Group did not wish to underestimate the difficulties which arose with regard to financial conglomerates, especially in connection with the more technical aspects of prudential supervision, it believed that there was a realistic prospect for developing some form of multidisciplinary understanding

101. *Id.* at 24.
102. *Id.* at 28.
103. *See infra* part VI.E.2. Additional difficulties exist with regard to the inclusion of insurance in addition to commercial and investment banking supervision in the considerations of the Tripartite Group.
104. *See supra* part VI.B. and note 67.
105. The Group was chaired by Mr. Tom de Swann, executive director of De Nederlandsche Bank. Further meetings were held in 1993, April 1994, and November 1994.
106. A copy of the Report is reprinted in 1994 REPORT, *supra* note 83, ch. VI.
107. The subgroup was chaired by Mr. Jonathan Spencer, head of the Insurance Division of the Department of Trade and Industry in the United Kingdom.
108. 1994 REPORT, *supra* note 83, at 56-61.

on the principles which would form the basis of future supervision of financial conglomerates.

E. Tripartite Group of Bank, Securities and Insurance Regulators[109]—Report on the Supervision of Financial Conglomerates, July 1995

As a result of the further work undertaken by the Tripartite Group, a final Report on the Supervision of Financial Conglomerates was published in July 1995 (1995 Report).[110] The stated purpose of the 1995 Report was to identify problems that financial conglomerates posed for supervisors and to consider ways in which these problems might be overcome.

The 1995 Report was, however, only issued as a discussion document in light of the informal nature of the Tripartite Group. A more formal joint forum is to be established by the Basle Committee, IOSCO, and the International Association of Insurance Supervisors (IAIS) to develop practical working arrangements between the different supervisors involved.[111]

The 1995 Report contains a number of detailed recommendations in connection with capital adequacy, supervisory cooperation, group structures, contagion, large exposures, shareholders' and managers' fitness and properness, information access, supervisory arbitrage, and mixed conglomerates.[112]

The specific difficulties which arise with regard to capital adequacy[113] are also considered in further detail with a number of practical examples being provided to illustrate the recommendations made.[114] An analysis of the responses received from members of the Tripartite Group to a questionnaire on the present arrangements for the supervision of financial conglomerates in each of the countries and regulatory areas involved is also provided.[115]

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109. Although formerly referred to as the Tripartite Group of Banking, Insurance and Securities Regulators, the July 1995 Report is stated to be issued by the Tripartite Group of Bank, Securities and Insurance Regulators.

110. Tripartite Group of Bank, Securities and Insurance Regulators, Report on the Supervision of Financial Conglomerates (July 1995) [hereinafter 1995 Report]. Copies of the 1995 Report were sent to the Basle Committee, the Technical Committee of IOSCO, and the International Association of Insurance Supervisors (IAIS) early in 1995. Although the three groups have not endorsed the contents of the 1995 Report, its recommendations have been accepted as a sound basis for further collaborative efforts.

111. The new group will propose improvements in cooperation and information exchanges between supervisors and develop principles upon which the future supervision of financial conglomerates could be based. The new group will continue under the present chair of the Tripartite Group, Mr. de Swann.

112. *See infra* part VII.H.7.

113. 1995 Report, *supra* note 110, ch. IV.

114. *Id.* app. III.

115. *Id.* app. II.

1. *Financial Conglomerates and Conglomerate Structure*

In the 1995 Report, the Tripartite Group agreed that the term *financial conglomerate* would be used to refer to any group of companies under common control whose exclusive or predominant activities consisted of providing services in at least two different financial sectors, namely, banking, securities, or insurance.[116] Although it was recognized that many of the problems which arose with regard to financial conglomerates would also affect mixed conglomerates offering nonfinancial or commercial services, in addition to at least one financial service, the primary focus of the 1995 Report would be on financial conglomerates.

2. *Supervisory Issues*

The 1995 Report identifies a number of specific supervisory issues in connection with which a series of supervisory recommendations are made.

a. Overall Approach to Supervision

The 1995 Report again notes that the growth of financial conglomerates makes it essential that supervisors in the banking, securities, and insurance sectors establish coordinated approaches to the supervision of the relevant institutions where supervision could not be effected on a purely solo basis. While solo supervision of individually regulated companies should continue to be the basis of effective supervision, a group-wide perspective had to be developed in connection with the prudential assessment of the group as a whole to ensure that supervisors could properly assess total group risks and the respective capital coverage as well as limit excessive or double-gearing.[117]

b. Assessment of Capital Adequacy

Fundamental difficulties did, however, arise in connection with capital adequacy determinations in light of the distinct prudential requirements applicable to banks, insurance, and securities undertakings. It was, however, accepted that an assessment of risk from a group perspective could be achieved by either consolidated supervision or supervision on a solo-plus basis.

With regard to consolidated supervision, the assets and liabilities of all companies within the group would be totaled and set against the parent company's capital.[118] Solo-plus supervision would involve individual institutions being supervised on a solo basis according to the relevant capital requirements set by their respective regulators. This solo supervision would, however, be complemented by a group-wide assessment of the availability of capital, which may be achieved through either aggregation, which involves totaling the solo capital requirements

116. The definition followed that contained in the earlier progress report; 1994 REPORT, *supra* note 83, at 53.

117. 1995 REPORT, *supra* note 110, para. 42.

118. Due to the emphasis on the parent or holding company, consolidated supervision is sometimes referred to as "top-down" supervision.

of the companies within the group and comparing the result with group capital, or risk-based deduction, which involves deducting investment by parent companies in subsidiaries and any capital shortfalls in the subsidiaries from the parent's capital, with the result being compared with the parent's solo capital requirement.[119]

In its earlier Progress Report, the Tripartite Group had unanimously recommended that capital adequacy be assessed on a group-wide basis in order to prevent double-gearing through the use of the same capital within separate parts of the group for regulatory purposes. There had, however, been no agreement on whether this assessment should be achieved on a solo-plus or consolidated basis.[120] Some members of the Group advocated undertaking further research to attempt to achieve, at least, partial harmonization of relevant prudential rules to permit consolidation of the separate financial areas involved. Other members favored the continuation of a solo-plus approach in light of the complex and labor-intensive nature of consolidation, its dependence upon the quality and consistency of the underlying accounts, which may be inaccurate or misleading, and the basic uncertainty that arose as to whether consolidation could satisfy all of the distinct concerns of each of the regulators concerned.[121]

In the 1995 Report, the Tripartite Group distinguished between homogeneous and heterogeneous groups in connection with which quantitative capital assessments could be made. With regard to homogeneous groups, an accounting-based consolidation was recognized as an appropriate technique.[122] This technique involves a comparison, on a single set of valuation principles, of total consolidated group assets and liabilities, with the capital requirements at the parent company level being applied to the consolidated figures.

A number of separate techniques were, however, examined in connection with heterogeneous groups. While block capital adequacy, which involves the classification and aggregation of assets and liabilities according to risk types, could achieve an accounting-based consolidation for heterogeneous groups, this technique depends upon the development of harmonized standards, which was considered impracticable in the foreseeable future.[123]

119. Solo-plus supervision is also referred to as "bottom-up" supervision due the emphasis on individual supervision.

120. Although bank regulators and securities regulators within the European Community increasingly rely on consolidated supervision, with possibly no solo supervision being undertaken at all, most insurance regulators and certain securities regulators in, for example, the United States, prefer solo-plus supervision. This preference is due to the perceived disadvantages involved in consolidation of additional costs, the possibility of supervisory involvement in nonfinancial activities, and the combination of distinct balance sheets to which different prudential requirements are applied.

121. While the Tripartite Group noted that the supervisory approach adopted should be flexible, it concluded that it was neither desirable nor possible to formulate a single supervisory technique applicable in all circumstances with the most appropriate approach generally depending on the structure and nature of the particular conglomerate.

122. 1995 REPORT, *supra* note 110, para. 108.

123. *Id.* paras. 109, 110.

Sufficient insight into the risks and capital coverage involved with heterogeneous groups could, however, be achieved through one of three alternative techniques: a building block prudential approach, which involves the use of the consolidated accounts at the parent company level;[124] risk-based aggregation, whereby the solo capital requirements of the regulated group are totaled and the result compared with group capital;[125] and risk-based deduction, which involves examining each company in turn, beginning at the lowest level of the group, with subsidiary investments being subject to a risk deduction element, calculated on the basis of the own funds of the subsidiary assessed on a solo-plus basis, less the capital requirement of the subsidiary, multiplied by the proportion of shares held in the subsidiary.[126]

The Tripartite Group concluded by recommending that each of these three techniques could form the basis of a set of minimum ground rules for the assessment of capital adequacy, the use of which could be developed on a mutual recognition basis.[127] A fourth total deduction approach was also noted, which would eliminate double-gearing but not provide any group assessment of the risks involved.

The 1995 Report concluded by noting that the type and structure of the conglomerate in question may determine which of the four techniques may be most appropriate for supervisory use.[128] Detailed recommendations are also provided with regard to subsidiaries which are not wholly controlled,[129] provisions with regard to suitability and availability of capital surpluses,[130] and provisions concerning the supervision of groups that include substantial nonregulated entities.[131]

c. Contagion

Contagion was specifically recognized as one of the most important issues facing supervisors in relation to financial conglomerates despite the advantages that may otherwise be available in terms of greater financial capacity and wider diversification of activities.[132] The Tripartite Group was, however, concerned that contagion could arise from transfer of lack of market confidence to distinct parts of the group as well as through direct intra-group exposures.[133] The use of firewalls in connection with the prevention of inter-conglomerate contagion,

124. *Id.* paras. 111-115.
125. *Id.* paras. 116-121.
126. *Id.* paras. 124-129.
127. *Id.* paras. 122, 123.
128. *Id.* paras. 130, 131.
129. *Id.* paras. 132-153.
130. *Id.* paras. 154-159.
131. *Id.* paras. 160-171.
132. *Id.* para. 48.
133. *Id.* paras. 49, 50.

through restrictions on intra-group transfers, which would otherwise breach individual company capital requirements, was also discussed.[134]

Although it was accepted that the provisions applicable to U.S. securities firms have been successful in the past, it was noted that these firms were less likely to fail due to the highly liquid nature of their balance sheets and the lack of any predisposition to support other companies within the group.[135] Banking groups, in contrast, were very sensitive to market funding and were consequently more prepared to prevent failure within the group.

d. Intra-group Exposures

It was recognized that specific difficulties arose with regard to intra-group exposures due to their exclusion from a consolidated balance sheet as a result of netting and due to the non-arm's-length nature of the transaction.[136] To deal with these difficulties, the Tripartite Group recommended solo supervision, at both the subsidiary and parent company levels, with appropriate reporting obligations,[137] liaison between relevant supervisors, and regulatory discretion to prohibit exposures where necessary.[138]

Supervisors should also monitor the extent to which supervised institutions within a conglomerate may be exposed to funding or trading difficulties arising as a result of shifts in market confidence.

The Tripartite Group recommended that regulators be made aware in specific terms of the purpose of any intra-group exposures, whether of a long- or short-term nature, and whether they were self-liquidating or likely to be repeated or rolled over.[139] In such circumstances, regulators must ensure that capital is increased, or activities limited, to ensure that no unacceptable intra-group exposures arise.

Some members of the Group recommended the introduction of predetermined limits on intra-group exposures to individual companies on an aggregate basis and, possibly, the imposition of reporting obligations where intra-group exposures exceeded a certain level.

e. Large Exposures at Group Level

The distinct approaches applicable to banking and insurance regulation in connection with large exposures were noted.

134. *Id.* para. 51.

135. *See supra* part IV.

136. 1995 REPORT, *supra* note 110, para. 56.

137. The relevant data may include: gross commitments; amount, nature, and residual maturity of commitments; profits and losses associated with intra-group transactions; and confirmation that business is being conducted on market terms and conditions. *Id.* para. 57.

138. *Id.* para. 63.

139. These exposures may arise from direct credit lines or from intra-group cross-shareholdings, trading operations, central short-term liquidity management, guarantees and commitments, and services provisions such as pension arrangements.

Although credit institutions were typically subject to specific limits on solo and consolidated exposures, insurance undertakings generally had to comply with asset diversification rules or risk-based capital incentives directed towards asset diversification.[140] The wide differences which existed, however, created considerable scope for regulatory arbitrage to such an extent that it was recognized that the gaps which existed would not be corrected within the foreseeable future.[141]

It was, however, agreed that a combination of large exposures to the same counterparty by different parts of the group could cause considerable difficulties to the stability of the group as a whole and, for this reason, a group-wide assessment had to be adopted. One solution was through the introduction of reporting obligations to the parent, or lead regulator, to ensure that they were able to assess significant group exposures to individual counterparties.

f. Conflicts of Interest

Specific conflicts of interest could arise when banking or insurance units within the conglomerate made loans or invested assets within the group outside usual approval processes or where investors, with substantial holdings in the conglomerate, had separate contractual relationships with businesses within the group which created shareholder and creditor conflicts.[142]

Although the 1995 Report makes no specific recommendations in these regards, the general recommendations concerning management and shareholder controls within conglomerates and, in particular, management autonomy and suitability of shareholders, should assist to avoid dangerous conflicts of interest arising.[143]

g. Fit and Proper Tests for Managers

Although supervisors generally had sufficient powers to confirm the suitability of managers of regulated firms, managers from other companies within the conglomerate and, in particular, from upstream entities, were not subject to any controls.[144] Where control may be exercised, directly or indirectly, by such managers, supervisors should have extended powers of approval or review.[145]

h. Transparency of Legal and Managerial Structures

Supervisors and regulators must be able to refuse to grant, or to withdraw, authorization in circumstances where conglomerate structures are not sufficiently transparent and conducive to group supervision.[146]

Supervisors and regulators should be aware of the legal and managerial structure of the conglomerate and be satisfied that all regulatory activities undertaken

140. 1995 REPORT, *supra* note 110, para. 64.
141. *Id.* para. 18.
142. *Id.* paras. 73, 74.
143. *See infra* parts VI.E.2.i. and j.
144. 1995 REPORT, *supra* note 110, para. 75.
145. *Id.* para. 76.
146. *Id.* para. 77.

within the group are supervised by a supervisor who can be relied upon to do so effectively and to provide the information necessary for group risk assessments. In connection with this supervision, the lines of accountability within a conglomerate and the form the accountability takes must be clear. This may involve the use of up-to-date organizational charts and information about ownership and managerial structures.[147]

In connection with large international financial conglomerates, the Tripartite Group insisted that supervisors had adequate powers, both before and after authorization, to obtain adequate information regarding corporate structures and to prohibit structures that impaired adequate supervision.[148]

i. Management Autonomy

One specific difficulty identified in connection with management structures was the sufficiency of independence and authority of the management of the regulated entity. To guarantee that conflicts did not arise between supervisory and group management requirements, it was necessary to ensure sufficient management autonomy in the regulated entity. For this purpose, supervisors had to know who was responsible for compliance with legal and supervisory requirements and be informed of any significant changes in shareholders of the regulated entity as well as significant management changes within the group.[149]

j. Suitability of Shareholders

A shareholder who exerted any material influence on a regulated firm should be subject to applicable fitness standards, both upon authorization and subsequently, with supervisors having adequate powers to intervene as necessary. Supervisory intervention will, for example, include powers of disinvestment and removal or restriction of voting rights, although it was recognized that intervention might not be possible where 100 percent or majority shareholders were involved.[150]

k. Rights of Access to Prudential Information

To ensure that separate regulators in one country and in overseas countries cooperate sufficiently to achieve the effective supervision of financial conglomerates, the Group made the following recommendations:[151] supervisory authorities must have sufficient legal powers to share prudential information with each other, including information on intra-group exposures subject to professional secrecy requirements; supervisors must actively exchange information, both nationally

147. *Id.* para. 78.

148. *Id.* para. 79. In connection with supervisors' powers, the 1992 Basle Banking Supervision Committee's minimum standards were recommended. *See* 1992 REPORT, *supra* note 67. The proposals put forward by the European Community were also noted. *See infra* part VII.

149. 1995 REPORT, *supra* note 110, para. 80.

150. *Id.* para. 81.

151. *Id.* para. 85.

and internationally, either within a single category or between distinct categories of supervisors; and supervisors must be able to obtain and share with other supervisors prudential information on nonregulated entities within the conglomerate to the extent that the information may be relevant for supervisory purposes.

The Tripartite Group again recommended that the supervisors and regulators of the various component parts of a group should appoint the supervisor of a dominant business in the group to act as convener whenever possible.[152] The convener should then be responsible for ensuring that all authorities involved were supplied with all necessary information, subject to public and professional secrecy requirements, and for the coordination of the risk assessment determination for the group as a whole. The convener should also be responsible for the coordination of any necessary supervisory action, especially in circumstances where two or more authorities act simultaneously.[153]

In the 1995 Report, the use of memoranda of understanding or protocols are recommended despite some disagreement on the benefits of such agreements in terms of the cost and time burden involved in negotiating them, especially with regard to information exchanges in the absence of any clear cause for regulatory concern. The matter was left for determination by the particular supervisors involved.[154]

Although the development of cross-sectoral meetings in each country was considered, the difficulties in organizing such meetings on an international scale were recognized. Again, no specific recommendations were made in this regard.[155]

Where external auditors had concerns about the financial and operational condition of a regulated entity, or the group to which the entity belonged, they should be required to report their concerns to the relevant supervisors. Any confidentiality problems that could arise in connection with these reporting obligations should be corrected through appropriate legislation.[156]

In connection with the external audit of the conglomerate as a whole, the Tripartite Group recommended that the principle of appointing one firm to provide an overall assessment of the group should be considered further, notwithstanding the existing appointment of distinct auditors to different parts of the group.[157]

1. Supervisory Arbitrage

While the scope for supervisory arbitrage in relation to core activities is limited in most jurisdictions, it was recognized that the residual possibility of arbitrage should be prevented. This could be achieved by ensuring that the same types of

152. *Id.* para. 86.
153. *Id.* para. 87.
154. *Id.* paras. 88, 89.
155. *Id.* paras. 90, 91.
156. *Id.* para. 92.
157. *Id.* para. 93.

risk undertaken within certain parts of the group are covered by identical amounts and structures of capital, irrespective of location and according to the "same-business, same-risk, same-rule principle," although this would require detailed harmonization of banking, securities, and insurance regulations.

In light of the unrealistic nature of this approach, the Tripartite Group recommended the adoption of a more pragmatic, but limited, arrangement involving an early warning system whereby supervisors would be required to report to each other on the establishment of conglomerate entities within their jurisdiction and on the transfer of assets, liabilities, or contingent liabilities between different parts of the group. This should enable supervisors to identify possible instances of arbitrage and take appropriate remedial action at an early stage.

m. Moral Hazard

Although the issue of moral hazard had not been considered in any detail in the April 1994 Progress Report, in the 1995 Report, the Tripartite Group expressed concern that supervisors may create the impression that unregulated parts of a group are regulated or supervised, even if only informally, as a result of information requests. No specific recommendations are, however, made in this regard.[158]

n. Mixed Conglomerates

In connection with mixed conglomerates, the Tripartite Group was concerned about the additional difficulties which arose with regard to capital assessments since supervisory practices could not be extended to apply to substantial nonfinancial entities. The Group, accordingly, recommended the use of some form of ring-fencing, the simplest form being the use of an intermediate holding company to create a subfinancial group within the conglomerate.[159]

Further recommendations are also made with regard to management quality, experience, and independence in mixed groups to avoid additional contagion difficulties and information requests in connection with other group activity which might adversely affect the regulated entity.[160]

3. *Conclusions*

The 1995 Report concludes by noting the importance of the need for more intensive cooperation between supervisors in the distinct fields of financial supervision involved and for further work to be undertaken in connection with the identification of impediments to the exchange of appropriate information between regulators.[161] Agreement was, however, possible on broad areas of approach which involved the

158. *Id.* para. 96.
159. *Id.* para. 100.
160. *Id.* paras. 101-103.
161. *Id.* para. 175.

development of general group-wide supervisory practices, although this was to be without replacing the solo supervision of individual group entities.[162]

Despite the difficulties which arose with regards to the different definitions of capital, types of risk, and capital requirements, considerable progress was made in identifying acceptable techniques for the assessment of capital adequacy in the 1995 Report. The Tripartite Group hoped that its efforts over the last two years would provide a firm foundation for further work to be undertaken in this area.

VII. The European Response

Despite the recent adoption and implementation within the European Community[163] of each of the principal directives in the banking, securities, and insurance sectors, as well as in connection with the free movement of capital,[164] the Commu-

162. *Id.* para. 176.

163. Under art. G.A(1) of the Maastrict Treaty, all references in the Treaty of Rome to the European Economic Treaty are to be replaced by references to the European Community. The European Union is created under art. A of the Maastrict Treaty with additional powers being conferred on it in respect of Common Foreign and Security Policy (art. J) and Home Affairs and Justice Policy (art. K). The Union is, however, expressly stated to be founded on the European Communities, that is, the European Community, the European Coal and Steel Community, and the European Atomic Energy Community (art. A, para. 3). The basic provisions concerning European banking and financial services remain within the renamed European Community Treaty, as amended by the Treaty Amending Certain Financial Provisions, the Single European Act, the Merger Treaty, the Greenland Treaty, the Acts of Accession, and the Maastrict Treaty. References in this article are, accordingly, to the European Community and not to the European Union. *See* Treaty on European Union, 1992 O.J. (C 191).

164. The adoption and implementation dates for the principal directives in the European Community financial law program are indicated below (Official Journal references not included here are provided in the notes following this note):

	Document No.	Adoption Date	Implementation Date
1. *Banking*			
First Banking Coordination Directive	77/780	12/12/77	12/12/79
Own Funds Directive	89/299	4/17/87	1/1/93
Second Banking Co-ordination Directive	89/646	12/15/89	1/1/93
Solvency Ratio Directive	89/647	12/18/89	1/1/93
Consolidated Supervision Directive	92/30		
Large Exposures Directive	92/121	12/21/92	1/1/94
Prudential Supervision Directive	95/26	5/18/95	11/18/95
2. *Securities*			
Investment Services Directive	93/22	5/10/93	7/1/96
Capital Adequacy Directive	93/6	3/15/93	7/1/96
Prudential Supervision Directive	95/26	5/18/95	11/18/95

nity has not yet been able to develop a complete response to the regulatory difficulties created by the growth of financial and mixed conglomerates. The Community is, however, considering the introduction of common minimum standards for the prudential supervision of financial conglomerates following the establishment of a working group in 1994 which reported its conclusions to the European Commission in the summer of 1995. As a result of these findings, the Commission will prepare a report which will be sent to Member States for consultation, following which a draft directive will be produced (the proposed Conglomerate Supervision Directive).

A considerable amount of progress has been possible within the Community with regard to the development of appropriate controls for the authorization and regulation of credit institutions and investment firms under the First[165] and Second Banking Directives[166] and the Investment Services Directive.[167] The supervision of financial groups, which comprise banking or investment subsidiaries, has also been secured under the 1992 Consolidated Supervision Directive[168] and 1993

	Document No.	Adoption Date	Implementation Date
3. *Insurance*			
Third Non-Life Insurance Directive	92/49	6/18/92	7/21/94
Third Life Insurance Directive	92/96	11/10/92	7/21/94
Prudential Supervision Directive	95/26	5/18/95	11/18/95
4. *Capital*			
Free Movement of Capital Directive	88/361	6/24/88	7/1/90

165. First Council Directive 77/780 of Dec. 12, 1977, on the Co-ordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions, 1977 O.J. (L 322) 30.

166. Second Council Directive 89/646 of December 15, 1989, on the Co-ordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions, 1989 O.J. (L 386) 1. The Second Banking Directive is supplemented by the Own Funds and Solvency Ratio Directives, which introduce a common definition of capital for credit institutions and a minimum risk-weighted solvency requirement of 8%. *See* Council Directive 89/299 of Apr. 17, 1989, on the Own Funds of Credit Institutions, 1989 O.J. (L 124) 16, *as amended by* Council Directive 91/633, 1991 O.J. (L 339) 33 & Council Directive 92/16, 1992 O.J. (L 75) 48; Council Directive 89/647 of Dec. 18, 1989, on a Solvency Ratio for Credit Institutions, 1989 O.J. (L 386) 14, *as amended by* Council Directive 91/31, 1991 O.J. (L 17) 20. Concentration limits for credit institutions were subsequently introduced under Council Directive 92/121 of Dec. 21, 1992, on the Monitoring and Control of Large Exposures of Credit Institutions, 1992 O.J. (L 29) 1, following the earlier Commission Recommendation 87/62, 1987 O.J. (L 33) 10.

167. Council Directive 93/22 of May 10, 1993, on Investment Services in the Securities Field, 1993 O.J. (L 141) 27.

168. Council Directive 92/350 of Apr. 6, 1992, on the Supervision of Credit Institutions on a Consolidated Basis, 1992 O.J. (L 110) 52. Under Directive 92/350, consolidated supervision was extended to apply to groups headed by a financial holding company. *Id.* art. 3(2). A financial holding company is a financial institution, the subsidiary undertakings of which are either exclusively, or mainly, credit or financial institutions, with at least one subsidiary being a credit institution. *Id.* art. 1.

Capital Adequacy Directive.[169] Similar progress with regards to insurance undertakings has, however, been impossible.

Although all of the principal directives were further amended by the Prudential Supervision Directive, which was finally adopted on May 18, 1995,[170] this made no attempt to integrate the three sectors. The Directive was adopted in response to the collapse of BCCI and only strengthened the powers of authorities with regard to refusal of authorization where a group structure was not sufficiently transparent, with the additional requirement that financial institutions maintain their head and registered offices in the same Member State. The Directive only otherwise introduced additional exchange of information provisions and reporting obligations for external auditors.[171]

In light of the very distinct requirements applicable to the regulation of insurance markets and the general difficulty in agreeing on common standards between all of the Member States of the European Community in this area, insurance undertakings have until now only been covered by separate insurance-specific measures and, even then, only on an individual, and not a group, basis.[172]

Over the last two years, the Commission has attempted to secure agreement on a set of common provisions for insurance groups, especially with regards to the supervision of intra-group exposures and the prevention of double-gearing (under a proposed Insurance Group Directive).[173] Instead of imposing consoli-

169. Council Directive 93/6 of Mar. 15, 1993, on the Capital Adequacy of Investment Firms and Credit Institutions, 1993 O.J. (L 141) 1. When a group of financial companies does not include a credit institution, the definition of a financial holding company in the Consolidated Supervision Directive is amended to include any financial institution the subsidiaries of which are either exclusively or mainly investment firms or other financial institutions, at least one of which is an investment firm. *Id.* art. 7(3). Under art. 7(2), the capital adequacy and large exposures requirements imposed by arts. 4 and 5 of the directive are to be applied on a consolidated basis.

170. The adoption of the directive had been considerably delayed as a result of the new conciliation decision-making procedure introduced under the Maastrict Treaty: art. G(61) adding a new art. 189b to the European Community Treaty. Although the procedure was intended to improve the decision-making processes within the Community by making them more democratic, through the introduction of further cooperation with the European Parliament, the effect can be substantially to complicate and slow down the adoption process.

171. *See* COM(94) final-COD 468, Brussels, May 2, 1994; COM(93)363 final-SYN 468, Brussels, July 28, 1993.

172. *See* CLIFFORD CHANCE, INSURANCE REGULATION IN EUROPE (1993); R. Falkner, *Insurance, in* FINANCIAL SERVICES IN THE NEW EUROPE (D. Campbell ed., 1992); D. Perry, *Insurance Regulation: Past, Present and Future, in* THE DEVELOPMENT OF THE LAW OF FINANCIAL SERVICES (Edward J. Swann ed., 1993); PAUL & CROLY, *supra* note 63. Three generations of measures have been adopted in the insurance area within the Community. These measures generally have extended the basic rights of an establishment that initially operated on a host country control basis to include services on a home basis and ultimately to establish services on a home basis with respect to both nonlife and life business: First Non-Life Directive 73/239 of July 24, 1973, O.J. (L 228) 3; First Life Directive 79/267 of Mar. 5, 1979, O.J. (L 63) 1; Second Non-Life Directive 88/357 of June 22, 1988, O.J. (L 172) 1; Second Life Directive 90/619 of Nov. 8, 1990, O.J. (L 330) 50; Third Non-Life Directive 92/49 of 18 June 1992, O.J. (L 228) 1; Third Life Directive 92/96 of Nov. 10, 1992, O.J. (L 360) 1.

173. *See* EUR. REP. NO. 2018, Feb. 22, 1995, sec. II, at 2; EUR. REP. NO. 2037, Apr. 29, 1995, sec. II, at 4. In connection with the commitment of Mario Monti, Financial Services and Internal Market Commissioner, to the completion of the insurance program, see EUR. REP. NO. 2040, May 10, 1995, sec. II, at 1.

dated supervision in this area, however, the early drafts of the proposed Insurance Group Directive have provided for solo-plus supervision with three capital options being provided to prevent double-gearing in insurance groups.

The capital options had to be included to deal with the very distinct forms of practice presently in operation across Europe. While the United Kingdom, Ireland, and The Netherlands have developed a deduction and aggregation method which operates on a "bottom-up" basis, France and Spain use a "top-down" form of accounting consolidation, with Denmark using a specific variant of deduction and aggregation. Any one of the three capital options provided will be deemed to secure adequate protection and be recognized as providing regulatory equivalence for the purposes of the proposed directive. Member States which do not have any relevant legislative controls in place at present will be required to select and implement one of the three options provided to ensure that a minimum set of standards will be in place across Europe. It is also understood that reporting obligations will be introduced in respect of intra-group transfers and additional provisions included in connection with the exchange of information between national regulators.

The difficulty which has arisen in connection with the adoptions of the Conglomerate Supervision Directive is that further work on the proposal cannot proceed until agreement has been secured on the terms of the proposed Insurance Group Directive. Even if agreement on insurance groups is possible in early course, however, it has to be expected that difficulties will remain in achieving a sufficient degree of equivalence between the full consolidation approach, applicable to banking and investment firms in Europe, and the new solo-plus options, being developed for insurance undertakings.

It has to be hoped that agreement on the final terms of the proposed Insurance Group and Conglomerate Supervision Directives can be reached in early course and that these measures may provide a valuable first model for the development of international standards in the area of conglomerate supervision.

VIII. Conglomerate Law—Conclusions and Comment

In light of the continuing growth and importance of complex financial and mixed conglomerates in global markets, it is essential that an effective and complete set of supervisory and regulatory rules and practices be developed in early course to protect the continued growth and stability of all of the separate markets involved.

One obvious difficulty which has arisen is in connection with the distinct structural approaches adopted with regards to risk separation in the United States and Japan, on the one hand, and in Europe and other countries, including many emerging markets, on the other. The consequent parallel development of complex Glass-Steagall and universal bank, and bank-assurance, based groups in global financial markets has clearly created very significant complications in the development of common standards of comparison and equivalence in these areas.

Of more importance, however, are the very basic differences which arise in the three principal financial sectors involved with regard to operational and solvency risks and their ultimate susceptibility to systemic collapse, in particular, as a result of possible loss transference within a single conglomerate.

It is in trying to achieve some comparable measure of supervisory and regulatory equivalence in respect of these core differences and, in so doing, to ensure a sufficient level of risk containment or insulation, but without unnecessarily limiting the proper competitive development of the markets, that the most significant challenges lie in international convergence. It has to be hoped that the final form of the proposed European Conglomerate Supervision Directive may provide a valuable model for the further development of global standards in this area.

At this stage, the following comments may be made with regard to the development of appropriate global standards for the regulation and supervision of financial conglomerates:

(1) Complete supervisory systems must be developed which facilitate the effective supervision of the legal and management structures of financial and mixed conglomerates and of the separate activities undertaken. Appropriate reporting obligations must be placed on regulated entities and effective exchange of information systems maintained between all of the relevant regulatory authorities within, and between, each of the countries involved.

(2) In addition to these general supervisory arrangements, more detailed systems must be developed for the assessment of capital sufficiency for conglomerates, including confirmation of capital adequacy, capital quality, and capital distribution within a group. In the event of common or harmonized standards being inappropriate, or impossible to agree, a set of global capital options must be adopted which secure a sufficient degree of equivalence in terms of risk containment or insulation and which are capable of mutual acceptance by all participating authorities.

(3) With regard to specific regulatory controls, appropriate systems must be developed to secure the suitability of management, both at the regulated entity and group level, and of all controlling shareholders. Proper controls must also be placed on the assumption of participations in financial and nonfinancial subsidiary companies and joint venture arrangements.

(4) All supervisors must have power to refuse, withdraw, or restrict authorization whenever a group, or any part of a group, is not subject to effective supervision, which power might extend to include the giving of directions as to place of incorporation or structure of operation.

(5) Appropriate safeguards must be developed to ensure that all of the risks of actual or potential conflicts of interests can be prevented or effectively contained, failing which business or trading restrictions should be imposed on specific undertakings.

(6) External auditors must be placed under appropriate reporting obligations while every possible effort must be made to develop necessary convergence in national and international accountancy standards in addition to the commonly used U.S. generally accepted accounting principles (GAAP) which may clearly be far from appropriate in many cases.

(7) Although a considerable degree of work has already been undertaken in the development of adequate systems of cooperation and exchange of information between national and international regulators, these efforts must be continued so that a complete network of global supervisory and regulatory relations can be established based on a sufficient degree of contact and confidence to ensure the effective supervision of all national and international conglomerates.

(8) The earlier work of the Tripartite Group of Regulators should be continued in a more formal forum to make sure that an agreed set of common rules or international guidelines for the effective supervision of conglomerates can soon be developed. The efforts, to date, of the Tripartite Group must be commended for the considerable results already achieved.

(9) At the present time, the most important operational guidelines in place remain the 1992 Basle Principles for the Supervision of Financial Conglomerates. Although relatively brief in their terms, the Principles do provide a valuable set of first rules for the proper identification and treatment of the principal difficulties that arise in connection with the supervision of financial and mixed conglomerates.

The Principles might, however, benefit from revision in light of the recommendations made by the Tripartite Group in its 1995 Report. Further amendments to the terms of the Capital Accord may also have to be considered in due course. It may be that a revised set of Minimum Standards for the Supervision of International Banks will be produced, which incorporates the amended principles, or a separate set of minimum standards issued for the supervision of financial and mixed conglomerates.

(10) Every attempt should be made to ensure that as many countries as possible accept, and effectively implement, the agreed standards for the supervision of financial conglomerates in all relevant areas of activity. The work of the Basle Committee has again been particularly impressive in this regard, especially through the extensive network of relations developed with other supervisory authorities, and regional groupings of supervisors, throughout the world. Securities and insurance regulators should attempt to develop comparable consistency in support for the rules adopted in their respective areas of activity.

(11) Insofar as certain countries, or specific financial centers, may be reluctant to introduce, or enforce, common standards for reasons of competitive, or comparative, advantage in a particular financial sector, all available forms of economic or political pressure must be used to ensure compliance

and to develop a complete global response to the difficulties created by conglomerate forms of business. It is essential that any gaps or faults which arise in the supervision of an individual institution are corrected at an early stage, failing which supervisors must exercise their powers of restriction or revocation.

(12) The provisional systems of new conglomerate law that are emerging in many countries are clearly very important steps in the creation of a larger global response to the need to develop a complete set of rules and administrative provisions for the effective management and control of the operations of internationally active financial institutions. Every effort should, however, be made to ensure that all domestic laws and administrative practices faithfully and fairly implement the relevant international guidelines so that all providers of financial services can compete on safe, but equal, terms without any local market distortions being created and possibility of regulatory arbitrage arising in the area of conglomerate supervision.

(13) These domestic provisions, and the international rules on which they are based, must, of course, be reviewed regularly and revised to ensure that flexible but effective responses are always possible as the structure and operation of the financial markets and financial operators change.

(14) Every opportunity should also be taken in developing the new rules to extend the effectiveness of any related areas of regulatory control, for example, with regard to money laundering or antifraud provisions, or in any other important area of legal or regulatory concern.

(15) One area of considerable residual difficulty which may arise is in connection with the coordination of national and international lender of last resort operations. This is clearly important in light of the increasingly close relations and consequent interdependence being created between all domestic and international financial markets. Even if complete agreement on this sensitive issue may be impossible in the short term, further efforts should be made to develop appropriate understandings or general guidelines over time to ensure that contagion caused by the failure of a particular conglomerate does not result in national or international market collapse.

(16) It is clear that a considerable amount of significant preparatory work has already taken place in the area of conglomerate supervision, and a substantial amount of initial progress achieved. It can only be hoped that the success of these efforts can continue and that a complete and effective set of controls for the supervision of financial conglomerates can be developed in early course. Success in this area will ensure that all national and international financial sectors can continue to grow and develop in a safe and stable manner and that the extensive opportunities being created in the new global markets for financial services can be fully realized.